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RECENT DEVELOPMENTS IN KERALA STATE FINANCES

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This paper was written in response to a felt need for an examination of recent developments in the fiscal sphere of Kerala; P. Balakrishnan articulated this need and conceptualised the study, initiated its commission and has piloted it to its conclusion with an admirable combination of urgency and patience. To him goes most of the credit for the positives of this paper. M. Govinda Rao also contributed to the formalisation of this work, and the comments of an anonymous referee have helped in further development of the paper. To all these persons, the author expresses his gratitude. The author has discussed various issues covered in the study with a number of persons in the Government of Kerala – he heartily thanks them for their help. Diwan Chand has helped with much of the data used, for which the author wishes to thank him. Finally, since the author has not heeded all the good advice proffered, the responsibility for any remaining errors of omission and commission are his alone.

ABSTRACT

This paper covers recent trends in a series of broad indicators of the financial health of the Government of Kerala with its developmental policy as the backdrop. It examines fiscal balances in Kerala that are not only important for macroeconomic reasons and Finance Commission mandated incentives but also for its own fiscal sustainability, and identifies revenue expenditures as the prime but not the sole determinant. The paper notes improvements in several fiscal indicators in the areas of indebtedness and expenditure pattern but relative stagnation in revenue mobilisation; it concludes that further fiscal consolidation is both necessary and feasible, pointing out some broad measures to achieve the same.

Keywords: Kerala, state finances, deficits, expenditure pattern, fiscal liabilities, taxation

JEL Classification: H7, H81, O23

1. Introduction and Broad Trends

At the beginning of the last decade, which also was the beginning of the 21st century, government finances in Kerala were in doldrums. The 'White Paper' brought out by the state government in June 2001 admitted that much in no uncertain terms while spelling out 'the crisis that the State exchequer is facing today' while conducting 'an analysis of the fiscal scenario' and 'an assessment of the total resources required at this juncture'. According to the White Paper, the "…Government is unable to fulfil its sovereign commitments to the people. It is unable to pay cash on cheques issued or make payments on items already included in the budget document."[1] "Courts are time and again ordering attachment of Government property, vehicles and furniture for failure to pay liabilities in time. There have been instances of contractors not being able to receive the payments for works undertaken by them…the Government has duly sanctioned those works and they, on their part, have executed the contracts. But, yet they are not being paid what is due to them. In quite a few cases, the Hon'ble High Court has had to intervene and order clearance of the dues."[2] This sorry state of affairs was bad enough on the basis of the state government accounts alone; it was further exacerbated when the public sector (i.e. including the state level public enterprises, particularly the State Electricity Board) were considered. Further, this was no transient cash-flow problem – it was clearly a structural problem that was building up over a long period of time.

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1. Government of Kerala (2001), p.3.
2. Government of Kerala (2001), p.4.

The adverse fiscal situation was considered by some researchers to be a part of a more general problem of unsustainable policy stance adopted by the state over a long period of time (see, for example, George, 1999 and Tharamangalam, 1998). This line of argument basically held that the 'Kerala model' of investing heavily in social infrastructure ignored physical infrastructure and industrial growth. While this policy did catapult Kerala into the limelight as an exemplary state in terms of human development, the financial returns to such investment for the state government, if any, were meagre, but the lasting expenditure liabilities were large, leading to an inherently unsustainable financial scenario. Large scale remittances from outside the state and income from plantations of cash crops could mitigate this lack of sustainability only to some extent and for only so long – the crisis in the state finances was inevitable.

Even so, a decade later, the state finances are clearly in a better position[3], as we shall see in the rest of this paper, although certain worrying features continue. This paper documents this change, tries to identify the areas of improvement that have driven this change and also points out weak spots that need to be attended to in the interest of preventing further recurrence of crisis in state finances.

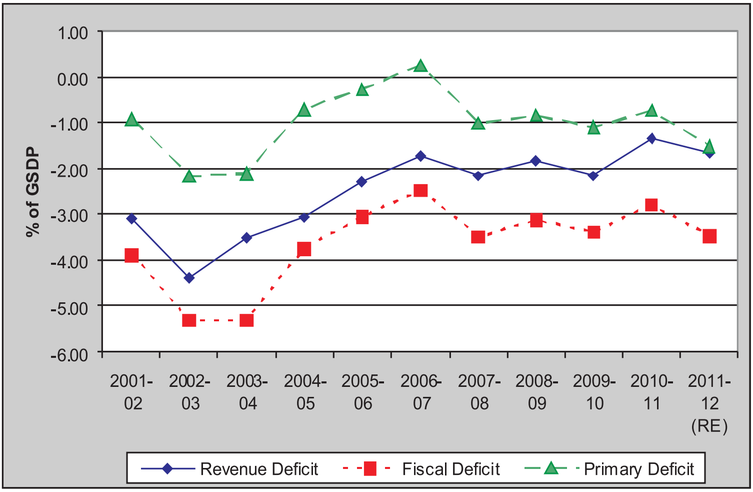
Annual figures of fiscal balances are most often used as summary indicators of changes in fiscal health; before the revenue and fiscal deficits of Kerala are presented below following this tradition, it may not be out of place to briefly discuss their significance and relevance at the state level. The central government and prompted by it, successive Finance Commissions since the Tenth have been pushing for state level measures to contain their revenue and fiscal deficits, mainly to promote

3. In a recent paper, George and Krishnakumar (2012) also agree; this paper covers similar ground as the present one, with differing emphasis on various aspects. As such, their contribution and the present one, prepared independently, could be considered complementary to each other.

macroeconomic stability. It is actually the primary responsibility of the centre to maintain such stability, and the incentives to the states to control their deficits within a given level (same for all the states) smacks of insensitivity towards the individual states' developmental concerns as also shifting the responsibility for macroeconomic stability, particularly when the centre does not follow its own fiscal correction path. However, their own fiscal balances are of importance to the states too, for a different set of reasons. First, given that states have no way of financing their deficits except by increasing their liabilities, low revenue deficits are necessary to ensure that the debt financing is confined to expenditures with at least expected positive rates of return, without which financial sustainability of the government can progressively worsen. Second, higher deficits translate into higher debt or liabilities, which automatically raise the cost of debt particularly for medium- and low-income states. Third, even without the cost of debt increasing, higher deficits mean higher indebtedness and hence higher interest costs leading to still higher deficits and a vicious spiral towards financial unsustainability. Kerala has tottered on the brink of such precipice already at the beginning of our reference period, as mentioned at the outset. Thus, while the straightjacket approach of the Finance Commissions may not be ideal from the point of view of the states in general and for Kerala in particular, a concern about the fiscal balances is certainly relevant in view of its past experiences.

Broad deficit indicators of Kerala – revenue, fiscal and primary deficits – for the period 2001-02 to 2011-12 as ratios of Gross State Domestic Product (GSDP) in current prices are depicted below in Figure 1. It can be seen that at the beginning of our reference period, revenue, fiscal and primary deficits became larger till 2003-04. The highest fiscal deficit was in 2002-03 at 5.3 percent of GSDP which was about the same in the next financial year. The highest revenue and primary deficits during the reference period were also recorded in 2002-03. All the deficit figures improved after 2003-04 reaching the lowest values of the decade in 2006-07, with primary deficits changing to a small primary surplus. Immediately afterwards, there was an increase in the deficits, but the figures were relatively stable (with small fluctuations) till 2009-10. Figures for 2010-11 show that fiscal deficits have improved from 3.39 percent of GSDP in 2009-10 to 2.79 in 2010-11; similarly, revenue and primary deficits also shrunk noticeably between 2009-10 and 2010-11. However, all the deficit indicators are expected to rise significantly in 2011-12.

Figure 1: Changing Fiscal Balances



Similar trends with minor variations can actually be observed for most states in India during this period, suggesting common influences. There are three common factors that are cited: the introduction of fiscal responsibility legislations strongly advocated by the 12th Finance Commission with substantial incentives, the high growth phase of the Indian economy that facilitated higher revenue generation by the states, and high growth in central tax revenues that benefited the state finances via the shared taxes. The recent deterioration in fiscal balances is also a cross-state phenomenon. It would be instructive to break down the change in fiscal deficits by its components to get a broad idea about the

Table 1: Decomposition of Changes in Fiscal Deficit

Items	2001-02	2002-03	2006-07	2009-10	2010-11	2011-12 (RE)
Fiscal Deficit	-3.88	-5.31	-2.49	-3.39	-2.79	-3.46
Own Tax Revenue	7.03	7.77	7.77	7.58	7.84	8.10
Own Non-tax Revenue	0.64	0.72	0.61	0.80	0.70	0.84
Shared Taxes	1.91	1.82	2.09	1.89	1.86	1.89
Grants	1.16	1.00	1.36	0.96	0.79	1.29
Revenue Expenditure	13.84	15.70	13.54	13.40	12.51	13.79
Of which, interest payments	2.95	3.14	2.72	2.28	2.05	1.95
Capital Expenditure	0.66	0.74	0.59	0.89	1.21	1.51
Net Loans and Advances	0.12	0.18	0.18	0.36	0.26	0.28

Source: Finance Accounts (various) and Budget documents of 2012-13, Kerala.

nature of adjustments that took place and the relative contribution of the components to the overall fiscal adjustment. Table 1 is designed to facilitate this decomposition.

It can be seen that the deterioration in fiscal deficit in 2002-03 (the year with the largest deficits) was despite increases in own revenues – both tax and non-tax. All other components contributed to the higher fiscal deficit, but the largest contribution was that of revenue expenditures. If we consider the change between 2002-03 and 2006-07 (lowest fiscal deficit), it presents a mirror image of the previous case, with a large reduction in revenue expenditures having the largest contribution in reducing fiscal deficit, even when own revenues declined. Further, reduction in interest payments played some role, but not a dominant one, in reducing revenue expenditures, implying a significant amount of genuine expenditure compression. Again, the increase in fiscal deficit in 2009-10 from 2006-07 was despite an increase in own revenues (this time mainly thanks to increasing non-tax revenues), attributable in equal measure to reduction in central transfers (both shared taxes and grants) and increase in all expenditure items (though the largest increase was in capital expenditures). The reduction in fiscal deficit in 2010-11 is largely attributable to a one percentage point decline in revenue expenditures. The expected rise in fiscal deficit in 2011-12 is again largely attributable to increase in revenue expenditures. The decomposition of changes in fiscal deficit thus clearly points to the crucial role played by revenue expenditures in most cases. Another point of interest is that substantive increases in expenditures are accompanied by increases in own revenues, but not enough to fully cancel out the increase in expenditures; also, the declining trend in central transfers over the decade has not helped in containing the deficits.

The manner of financing the fiscal deficits also throws some light on the fiscal management. Table 2 provides the necessary data. Of course, at the state level, it is well-known that fiscal deficits have to be

Table 2: Financing of Fiscal Deficit in Kerala

(Rs. Crore)

	2000-01	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12 (RE)
Fiscal Deficit	3878	4182	3822	6100	6345	7872	7731	11300
Financed by:								
Public Debt (net)	2091	4001	4253	4211	5271	4850	5214	8062
Contingency Fund (net)	0	13	2	-80	74	-20	-8	0
Public Account (net)	1907	331	-288	1891	915	3062	2525	2760
Withdrawal of Cash Balances	-120	-163	-145	78	85	-20	0	478

Source: Budget in Brief, 2012-13, Kerala.

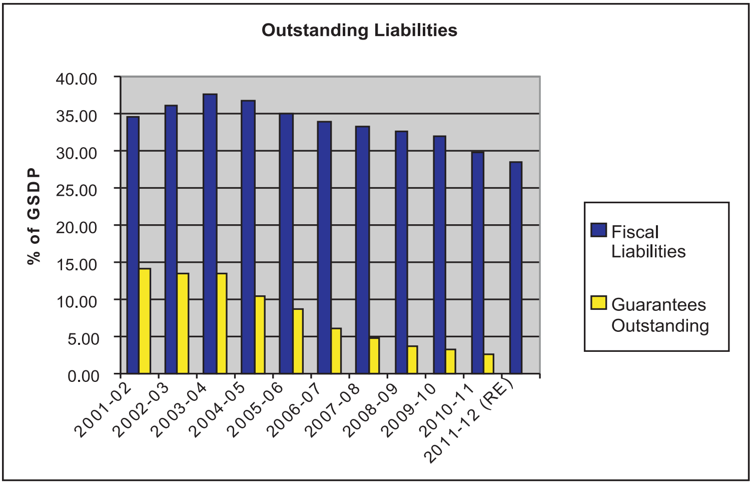
financed by some kind of debt/liability or another. What the table shows is essentially the financing by the type of liability in each year. As can be seen, the two main sources are internal debt and public accounts. While the financing of fiscal deficit with internal debt is relatively straightforward, that with funds from public accounts has an added dimension. Since public accounts reflect the operations of a government acting more or less like a bank, financial safety requires that if money is taken out of it in any year, it should be replenished as early as possible – draining the public accounts is against financial integrity. The funds in the public account are not meant to be a regular source of financing the government's day-to-day expenditures. In practice, the state government has withdrawn substantial amounts from the public accounts in every year except 2006-07 since 2005-06; the amounts have also been rather hefty in the last three years. Clearly, this adds to the financial instability of the government and puts a question mark on the role of the government as a banker.

2. Indebtedness

Fiscal deficits at the state level can be met only in two ways – by liquidating assets or by incurring some kind of financial liability, since the option of deficit financing is not available at the state level. As such, any state running persistent fiscal deficits is likely to have a relatively high level of indebtedness, defined broadly as all liabilities that have to be paid back at varying rates of interest (including zero). The accounting definition of debt does not include the public account liabilities, but these are a part of the indebtedness in fact, and should be considered as such.

Figure 2 provides the trend of fiscal liabilities over the reference period. It also depicts the quantum of one of the major contingent liabilities, *viz.* the guarantees outstanding (except for the last year, for which no data on guarantees outstanding was available). It can be seen from the graph that the fiscal liabilities were at a high level of about 34

Figure 2



percent of GSDP at the start of our reference period, rising further to about 38 percent before levelling off and declining to a level of below 29 percent in 2011-12 (revised estimates). It may be noted that it remains higher than the Finance Commission recommended 25 percent of GSDP and the decline needs to be maintained for some more time, although the declining trend clearly allays the fear of 'exploding' debt levels and also unsustainability to a great extent.

High indebtedness causes a vicious circle of higher interest burden, leading to higher deficits and then on to further borrowing to finance the higher deficits. It therefore is fortunate that this circle did not come into play in the state, helped by various factors including smaller deficits, softening of interest rates, debt relief and rescheduling by the Government of India (GoI) pursuant to Finance Commission recommendations, and possibly better debt management also. All types of liabilities do not bear the same interest rate, and one of the aspects of good debt management is to exploit various debt instruments in ascending order of interest rates, using that with the lowest interest rate to the maximum extent possible and so on. The substitution of Plan loans from GoI (the major part of indebtedness to GoI) by market borrowings has also helped to keep interest costs at a lower level because the latter source had lower interest costs. Market borrowings, as a result, have increased from about 17.5 percent at the end of 2001-02 to more than 41 percent at the end of 2011-12 as a share of total outstanding liabilities. The share of small savings loans (NSSF), probably the most expensive in terms of interest costs, has also come down from almost 16 percent in 2004-05 to 12 percent in 2011-12 (Table 3). Of course, greater reliance is placed on the less expensive state's own small savings scheme, as reflected in the figures at row C(i). The benefit of all this is easily seen in the fact that interest payments as a ratio of revenue expenditures has declined from 21.34 percent in 2001-02 to 16.41 percent in 2010-11, and further to 14.11 percent in 2011-12, creating fiscal space to that extent. As a ratio of GSDP, the decline was from 2.95 percent to 2.05 percent, and then to 1.95 percent in 2011-12 (RE).

The graph (Figure 2) also shows the striking decline in the guarantees outstanding, reducing the financial risk of the state government substantially. However, there are other types of contingent liabilities like bills outstanding, accumulated losses of public sector undertakings and amounts under litigation. While reliable and up-to-date information on these are not available in the public domain, these are also likely to be significant; one can only hope that these types of contingent liabilities are also on the decline.

All states have both financial liabilities and assets. While there is no prescription of financial prudence that says such prudence increases monotonically with the coverage of financial liabilities by financial assets (too much of financial assets could simply signify idle resources that could be utilised to build up physical assets), there is usually an ill-defined but reasonably well-approximated optimum for each state that is required to liquidate at least a substantial part of the liabilities, when

Table 3: Components of End-Year Outstanding Fiscal Liabilities of Kerala

(%)

		2001	2005	2009	2010	2011	2012 (RE)
A.	Internal Debt, *of which*	29.61	49.50	58.54	57.78	58.83	60.33
	(i) Market Borrowings	17.47	21.94	32.07	34.61	37.27	41.39
	(ii) Special Securities issued to NSSF	3.93	16.10	17.92	15.64	14.28	12.10
	(iii) Loans from Banks and Fin. Instn.s	2.46	11.47	8.55	7.53	7.28	6.84
B.	Loans and Advances from Govt. of India	23.69	12.36	9.06	8.40	7.71	7.06
C.	Public Account	46.59	37.94	32.26	33.72	33.38	32.54
	(i) Small Savings, Provident Funds etc.	39.57	33.78	27.82	28.37	28.84	28.19
	(ii) Reserve Funds	0.35	0.74	0.63	0.40	0.39	0.30
	(iii) Deposits and Advances	6.68	3.42	3.80	3.94	4.15	4.04
D.	Contingency Fund	0.10	0.19	0.14	0.10	0.08	0.07
E.	Total Liabilities (A to D) (Rs. Crore)	25754	43786	66305	75055	82486	93404

Source: Based on data from Budget in Brief 2012-13.

called for. Table 4 provides comparative data on the ratio of financial assets to liabilities in selected states of India.

Table 4: Ratio of Financial Assets to Liabilities in Selected States of India

(%)

State	2008-09	2009-10	2010-11
West Bengal	30	28	26
Punjab	43	41	39
Kerala	39	39	41
Rajasthan	70	67	71
Gujarat	74	71	72
Uttar Pradesh	67	73	77
Haryana	88	80	77
Maharashtra	77	76	78
Tamilnadu	82	81	80
Jharkhand	83	85	89
Andhra Pradesh	89	92	94
Odisha	86	89	96
Goa	90	90	98
Karnataka	114	105	109
Bihar	104	109	118
Madhya Pradesh	101	109	118
Chhattisgarh	122	125	143

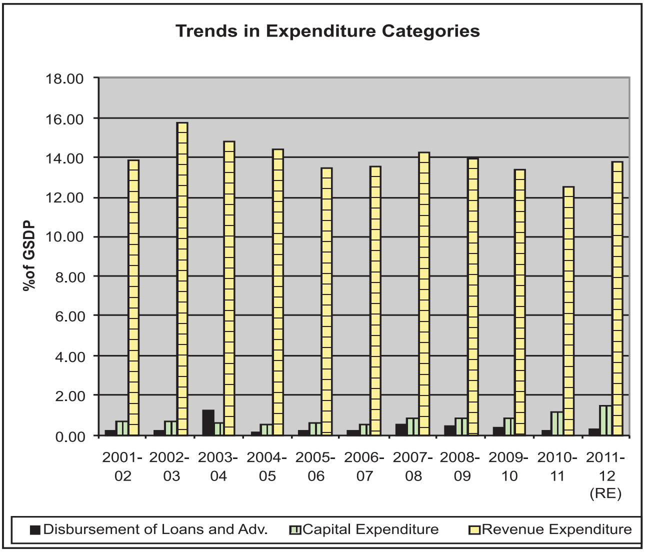
Source: Union and State Finances at a Glance 2010-11, Comptroller and Auditor General of India, New Delhi

The table shows the ratio of financial assets to liabilities in Kerala as the third lowest, and what is more, around 40 percent only. West Bengal has the lowest ratios in all three years for which data are reported here, with Punjab roughly in the same position as Kerala. Apart from these three states (it may be pertinent to recall that these states alone were considered particularly ‘fiscally stressed’ by the last Finance Commission), the lowest ratios are in Rajasthan, but at a substantially higher level of around 70 percent. Obviously, the first three states are in a precarious position with respect to coverage of financial liabilities with financial assets.

3. Expenditures

One of the consequences of the special emphasis put on social infrastructure and welfare by the state is that the structure of expenditures gets heavily biased towards revenue expenditures. Such a policy also has a tendency to create vested interests in the continuation of the same policy *ad infinitum*. Whether this is the case in Kerala or not is a moot point; for our purposes, it suffices to note that given limited resources, and the state’s clear preference for social infrastructure and welfare, revenue expenditures overwhelmingly dominate total expenditures, with capital expenditures traditionally accounting for a very small share (Figure 3). The third category of expenditures, loans and advances,

Figure 3



account for an even smaller share and are dominated by loans of doubtful utility to various public enterprises that are often known to be not in a position to repay them anytime in the foreseeable future. In recent years (2007-08 onwards), loans and advances are further shrinking while capital expenditures have increased a little.

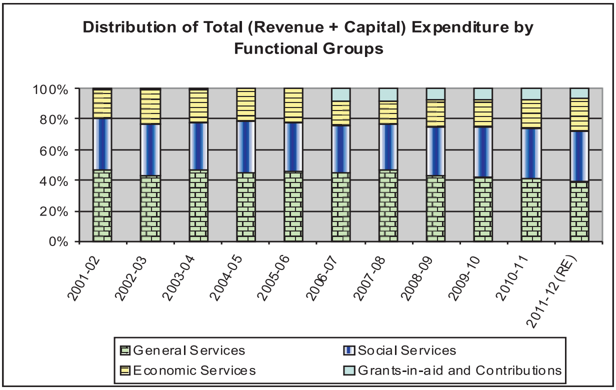
The low levels of capital expenditures, although dominated by economic services, have been partly responsible for the relatively poor industrialization of the state, as has been previously noted by other authors. This conceptually raises the problem of limited base for raising revenues; the extent of its applicability to Kerala is examined later while discussing revenue performance of the state. But apart from this possible implication for the fisc, the relatively low degree of industrialization implies a low growth of employment opportunities outside the traditional agriculture and services sector. This particular aspect is more important for the state given its high level of unemployment as indicated by the number of persons registered in Employment Exchanges seeking jobs relative to the working population.

The dominance or otherwise of the social services in total expenditures can be easily and directly checked by examining the distribution of total (revenue + capital) expenditures by functional groups. Figure 4 presents the relevant trends over the reference period, and it can be seen that the distribution is fairly stable at around 40 percent for general services (including interest payments), around 35 percent for social services and about 20 percent for economic services. From 2006-07, transfers to local bodies accounts for 7-8 percent of total expenditures[4]; till 2005-06 its share was negligible and the share of the other three were roughly proportionately higher. The expenditure share confirms the policy bias in favour of social services. Equally important,

4. Transfers to local bodies under specific functional categories are included under respective functional categories – these are essentially general purpose transfers.

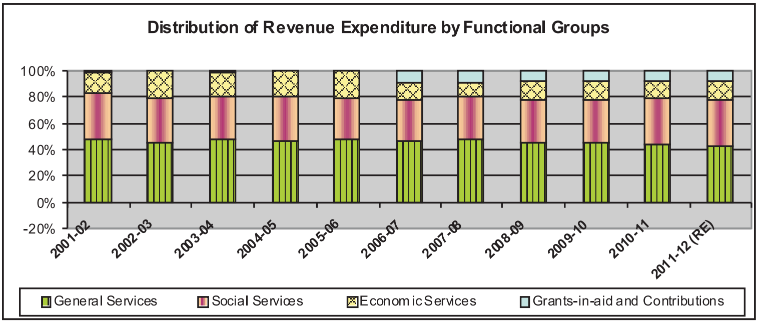
it is to be noted that the share of general services appears to be unduly large (even conceding that a large part of the same consists of interest payments); what is more, although the share of interest payments has shrunk substantially over the reference period, that of general services has declined only marginally. This implies that the fiscal space created by the smaller share of interest payments has largely been devoured by expanding and/or more expensive administrative machinery with hardly any increase in developmental expenditure.

Figure 4



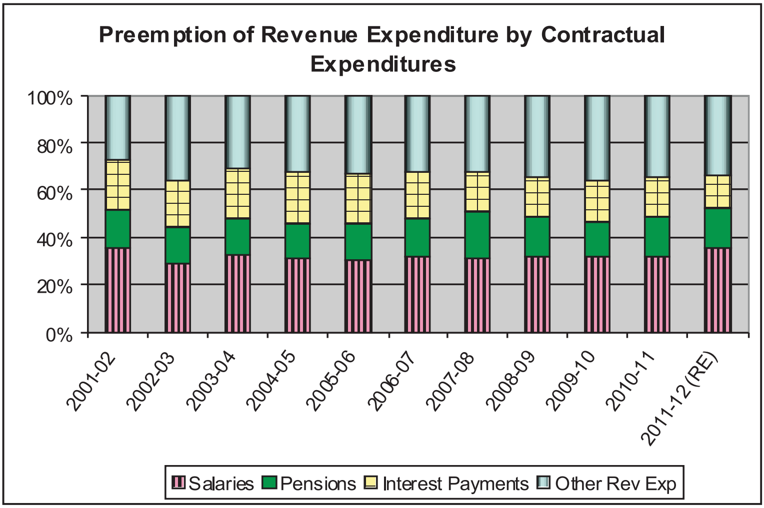
As is to be expected from the predominance of revenue expenditures in total expenditures, the shares seen above largely reflect the same in revenue expenditures alone, as depicted in Figure 5.

Figure 5



Another interesting issue relates to the available fiscal space for discretionary developmental expenditures. A large part of state level public expenditures often consists of contractual expenditures; these include salaries, wages and pensions (other retirement benefits too), and interest payment at the minimum. These are inflexible in the short run; expenditures in the nature of entitlements add to the inflexibility. However, in practice entitlements are not fully inflexible, and hence we do not include them here in contractual expenditures. It is only after meeting the minimum contractual expenditures that any choice regarding expenditure allocation can be exercised. Thus, it is instructive to examine the pre-emption of expenditures by these minimum contractual expenditures. Figure 6 provides the necessary information with respect to revenue expenditures, given the predominance of revenue expenditures in the total.

Figure 6



The figure shows that the degree of inflexibility in the expenditures has declined over the reference period from about three-quarters at the beginning of the reference period to around two-thirds at the end.[5] This is a welcome trend as it makes space for more of truly developmental expenditures; ways of further improving this flexibility have to be explored continuously.[6] At the same time, it should be noted that entitlement programmes also increase inflexibility in expenditure allocation, and an open-ended overly generous programme like rice at Re. 1/Rs. 2 per kg. can potentially be disastrous for financial stability in a state like Kerala where the very success of the government in terms of the coverage of the public distribution system (PDS) can become its enemy, driving the subsidy bill on this count to a high level in a short time. In fact, the phenomenal growth of the food subsidy bill of the state government in the last 3/4 years bears testimony to this apprehension.

4. Revenue Receipts

Revenue receipts are dominated by tax revenues in most states of India, and Kerala is not an exception to this. Also, the popular perception and public policy being heavily influenced by the 'welfare state' concept, non-tax revenues are not large. Again this is in conformity with most of the states in India. The other two sources of revenue receipts are shared taxes and grants from the Union government, and hence largely exogenously determined. The broad structure of revenue receipts (Figure 7) thus has little that is remarkable or special to Kerala.

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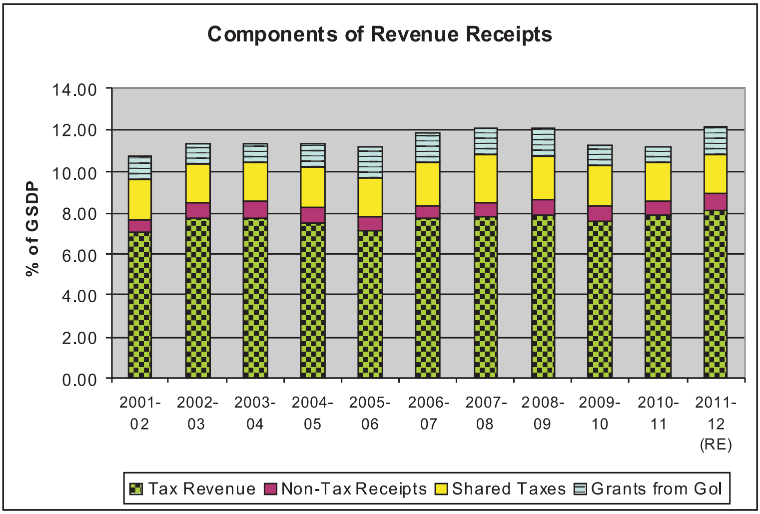
5. This is likely to change for the worse, at least temporarily, with the implementation of pay revision; this would apply to pensions too. Unless there is an unlikely compensating variation in revenue generation, the contractual expenditures may claim about 75 percent of revenue expenditures again for at least 2-3 years.

6. Once the funded pension scheme kicks in substantially with respect to actual pension payments, the flexibility should improve commensurately, but that is a long way off yet.

Figure 7



Total revenue receipts have been fluctuating between 10 and 12 percent of GSDP throughout the reference period. This is actually lower than several states in India, but of those not many have higher own revenues (tax plus non-tax). The central transfers (shared taxes plus grants) received by the state account for less than half of its own revenues, which explains the relatively low level of total revenue receipts despite a relatively high level of own revenues. However, even in terms of own revenues, Kerala has fallen behind two contiguous states of Tamilnadu and Karnataka, despite having the advantage of an actual revenue base (disposable income) larger than the denominator (GSDP) thanks to the substantial amount of remittances (Table 5). On the other hand, the share of the secondary sector in the GSDP that is usually positively related to revenue generation is only around 23 percent in Kerala, which acts as a constraint on revenue generation. It is the tertiary sector which has grown much more than any other sector, and this sector contributes relatively less to the state exchequer.

Table 5: Tax GSDP Ratio of Selected States

(Percentage)

State	Average of 1999-2002	Average of 2008-11
Andhra Pradesh	7.27	7.90
Bihar	4.24	5.33
Chhattisgarh	6.38	7.21
Goa	6.80	6.20
Gujarat	7.74	6.58
Haryana	7.78	6.23
Jharkhand	4.85	6.32
Karnataka	8.18	9.29
Kerala	7.81	7.77
Madhya Pradesh	5.49	7.47
Maharashtra	7.49	6.82
Odisha	5.16	5.54
Punjab	6.73	6.67
Rajasthan	6.14	6.49
Tamilnadu	8.63	8.43
Uttar Pradesh	5.45	6.63
West Bengal	4.22	4.28

Source: Annexure 7.9 of 12th Finance Commission Report for 1999-2002 and computed (2008-11). Tax data are from Finance Accounts and GSDP data from CSO for both sets of years.

The low levels of non-tax revenues result from several factors like small interest receipts, negligible amount of dividends received and low levels of user charges. Attempts have been made in the past to examine this aspect and take corrective action, but none of these has had much of revenue impact. While its revenue potential from physical infrastructure services is limited in Kerala until it makes substantial investments, areas like tourism[7], forestry and wildlife, health and minor minerals could possibly be tapped for higher levels of non-tax revenues. The central transfers have been low mainly because of two factors: (a) the formula for the *inter se* distribution of several of these transfers including the biggest one of shared taxes is progressive in nature; Kerala, being a middle income state, does not receive a large share; (b) many of the centrally sponsored schemes and central plan schemes effectively bypass Kerala by their very nature (the high literacy rate of Kerala makes it a non-focus state for Sarva Shiksha Abhiyan, to cite an example and the relatively low incidence of poverty causes smaller allocations of all poverty alleviation programmes, to cite another).[8]

Like most other states of India, again, the largest share of tax collections are from sales tax/VAT (Figure 8). On an average, this tax contributed more than 70 percent of the own tax revenue. The category of stamp duties and registration fees is a distant second followed by state excise and motor vehicle taxes. Taxes on the agricultural sector (land revenue and agricultural income tax) contribute an insignificant share despite the presence of plantations of several cash crops. In the area of taxation, the biggest concern at this moment is a successful transition to the proposed Goods and Services Tax (GST), but the uncertainties surrounding this transition have proved to be rather frustrating. A destination based GST in the place of origin-based elements like the central sales tax would be highly advantageous for a

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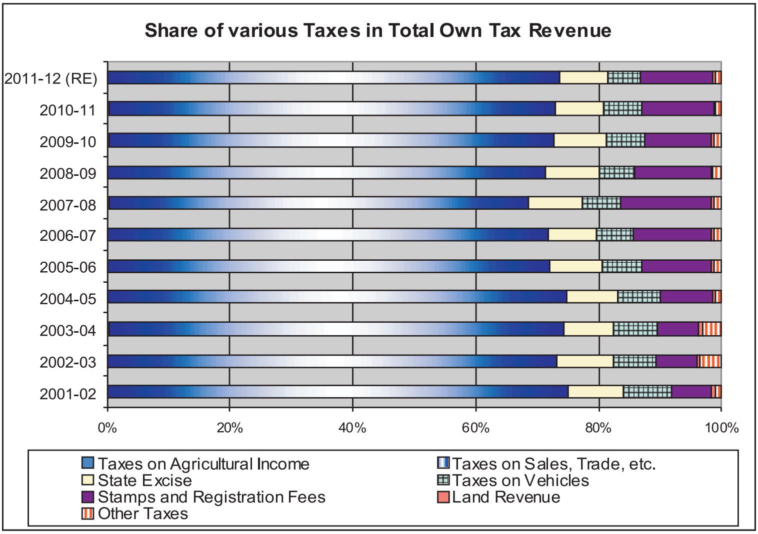
7. The previous experience with direct government interventions in supplying tourist infrastructure, particularly hotels, may justifiably cause some derision with this suggestion. It is not my intention to suggest that the state should have more of the same; rather, it is suggest that the government could probably do better by tying up with private sector in this area. Properly negotiated deals should rake in much more revenues for the government than on its own steam and salvage the investments already made now that the government has successfully established Kerala as a major tourist destination.

8. This is a point made by the Kerala Public Expenditure Review Committee (Second) too in their report of June, 2010.

Figure 8



net importing state like Kerala, and should raise its revenues. For the present, the latest budget has utilised the two most obvious revenue raising measures, those of raising the standard 4 percent rate to 5 percent and 12.5 percent rate to 13.5 percent. However, there is scope to raise further revenues from two main sources: more appropriate use of the value added tax, and bringing the mushroom growth of neighbourhood stores into the tax net. The first point arises mainly because of excessive use of the compounding system that practically defeats the purpose of introducing VAT principles, by eschewing proper assessments as also not covering the entire sales chain. As for the second, most of these neighbourhood stores report turnovers below registration requirements for sales tax/VAT, but do have some taxable capacity that should be tapped. It would probably not be administratively feasible to bring them under the VAT system, but either a small turnover tax or appropriate taxation through the local bodies (perhaps through profession tax, or through license fees) should be feasible.

The central legislation on stamp duty is also slated for substantial overhaul, and once this is achieved the state can follow up with its own legislation to realize higher revenues. Of course, the state will have to modernise its tax administration too in order to get the full benefit of this development. In fact, this is an observation that is probably applicable to much of tax administration in Kerala in general, but such modernisation has to be tailored to the requirements of each tax separately.

The state has already taken steps to reform the motor vehicle taxes by basing the taxation of automobiles on price instead of physical parameters like seating capacity or laden weight. It now needs to decide the frequency of the tax that it would like to proceed with – one-time tax or an annual tax. There are pros and cons of both options, but for certain legal reasons it may be better to opt for an annual tax.

Regarding state excise, the CAG had published a Stand Alone Report last year that assessed the working of the department. It was of the opinion that the department took seriously only its role of regulation and enforcement, and not of a revenue generator. Essentially, bulk of the revenues flow from the public sector distributor of foreign liquor – the Beverages Corporation – without much effort, and other revenues are minimal, implying little effort from the department. For example, revenues from country liquor (arrack) and country fermented liquor (toddy) are very small, nowhere near commensurate with the consumption of the same. The above report believed that substantial additional revenues could be generated by the department with only a little extra effort.

Among other taxes, the main problem with electricity duty relates to its regular collection by the state electricity board without regular transmission of the same to the government. This happens to such an extent that although on paper the SEB is the largest generator of profits among the public sector undertakings in the state (pushing up profitability of the public sector enterprises as a whole), much of these profits may disappear if the improper retaining of electricity duty collected were to be eliminated. Apart from making a dent in the revenue receipts of the government, this practice has the added disadvantage of breeding some complacency about the functioning of the SEB.

5. Concluding Observations

The preceding brief survey of the state finances of Kerala over the last ten years indicates a broad outline of fiscal policy to be adopted over the medium term, on which there seems to be some amount of consensus. The prime mover of this policy ought to be a significant step up of public investments in infrastructure services as a prelude to an industrialization drive without introducing any sudden major shock to the social infrastructure and welfare activities. For this, it is necessary that the capital expenditures be stepped up significantly and persistently. If at least revenue balance is maintained (revenue deficit ≤ 0) and no substantial surplus is targeted, this will automatically meet the concerns of social infrastructure and welfare activities, since these are almost entirely embedded in revenue expenditures. This would allow the entire fiscal deficit (increase in liabilities) to be utilised for the required investments in physical infrastructure. In terms of both the Medium Term Fiscal Plan of the state and the adjustment path recommended by the 13^{th} Finance Commission, this would allow 3.5 percent of GSDP for 2012-13 and 3 percent thereafter, to be invested in physical infrastructure. But this is unlikely to be anywhere near adequate, necessitating leveraging of these resources with private investments for the identified projects, perhaps through the PPP route. Splitting projects into separate tasks to be handled by government/private sector on their own is also a possibility.

Any increase in revenue receipts or savings in expenditures that can create a revenue surplus will be a welcome additional source of funds; this is not totally unrealistic since there is scope for raising resources through better tax administration and policies (by its own standards, tax performance in Kerala has slipped in the last decade) and appropriate calibration of non-tax revenues (even ignoring the state lotteries). However, although some researchers believe that "… the state has not been able to make any headway in correcting its fiscal imbalance on the revenue side though expenditure growth has been moderated" (Nambiar, 2009), this is not quite correct, as seen above. There are possibilities of economising on expenditures also that need to be assessed and acted upon; for example, a detailed assessment of requirement of schools, their capacity and number of teachers required is likely to throw up a significant amount of excess capacity in the public sector[9] – this can be the basis for a properly formulated plan for gradually reducing the excess capacity. There are also significant gains to be had from an aggressive reform programme of public enterprises. Unfortunately, despite setting up Committees with such an intent, the actual progress is very much like 'one step forward, two steps backward'. George and Krishnakumar (2012) also point out some bad practices (like parking funds booked as expenditures in various deposits without actually spending them) in the area of financial management that go towards inflating expenditures. The Public Expenditure Review committees have also made some suggestions (e.g., monitoring the receipt of due amounts from various central transfers and monitoring the effective utilisation of centrally sponsored schemes, or raising the retirement age) that need to be seriously considered for implementation.

Further additional resources can be had by raising loans through public enterprises; however, this is a risky proposition given the track record of the public enterprises and it would be of utmost importance to ensure a realistically projected revenue stream that would at least cover the debt servicing costs, for each investment project. This requires a

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9. The well-known issue of 'protected' teachers and lecturers provides a pointer in this direction, but their numbers may underestimate the true excess capacity.

thorough project appraisal system that has to be introduced as an institutional reform as soon as possible.

Although the falling liabilities/GSDP ratio allays any fears regarding debt sustainability in at least the medium term, the extremely low coverage of financial liabilities by similar assets does underscore the financial fragility of the state government. The basic cure has to come from efforts keeping the fiscal deficit low, which would automatically reduce the level of liabilities and improve the coverage with the same level of financial assets. Debt management of the government also has to be improved to deliver a debt package at the lowest feasible cost. Costly sources of debt like NSSF funds (which seems to be still the second largest source of internal debt) or those from NCDC have to be kept at the minimum feasible level, relying as much as possible on cheaper debt such as market borrowings. Kerala also has its own indigenous public debt instrument of Treasury Deposits, which appears to be a cheap source of funds, helping to keep the cost of debt lower than what it would be otherwise.

The story of public finances in Kerala over the last ten years shows a significant improvement with respect to various parameters starting from a crisis-like situation. This story has one moral for our purposes: if matters could be improved significantly from such a bad situation as depicted in the White Paper, why should further improvements be not possible from a healthier base, when the scope for it exists?

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ANNEXURE

[All budgetary data are from Finance Accounts of Kerala (various issues), except those for the year 2011-12 (RE), which are from the budget documents of Kerala, 2012-13.]

Table A.1: Deficits as Ratio of GSDP

(%)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit
2001-02	-3.09	-3.88	-0.93
2002-03	-4.39	-5.31	-2.17
2003-04	-3.52	-5.30	-2.11
2004-05	-3.08	-3.73	-0.70
2005-06	-2.29	-3.06	-0.28
2006-07	-1.72	-2.49	0.24
2007-08	-2.16	-3.48	-1.01
2008-09	-1.83	-3.13	-0.83
2009-10	-2.16	-3.39	-1.11
2010-11	-1.33	-2.79	-0.74
2011-12 (RE)	-1.67	-3.46	-1.51

Table A.2: Fiscal Liabilities as a Ratio of GSDP

(%)

Year	Fiscal Liabilities	Guarantees Outstanding
2001-02	34.44	14.02
2002-03	35.94	13.43
2003-04	37.51	13.39
2004-05	36.64	10.33
2005-06	34.95	8.72
2006-07	33.92	6.12
2007-08	33.18	4.75
2008-09	32.59	3.75
2009-10	31.94	3.23
2010-11	29.75	2.68
2011-12 (RE)	28.59	N.A.

Table A.3: Allocation of Revenue Expenditure

(Rs. Crore)

Year	General Services	Social Services	Economic Services	Grants-in-aid and Contributions
2001-02	5611	4076	1908	67
2002-03	6678	5038	2982	58
2003-04	7398	5025	2999	73
2004-05	7986	5879	3307	-3
2005-06	8756	5896	3772	0
2006-07	9723	6478	2712	1912
2007-08	12184	7790	2819	2099
2008-09	12667	9363	3929	2265
2009-10	13935	10467	4241	2489
2010-11	15418	12111	4357	2778
2011-12 (RE)	19022	16090	6498	3450

Table A.4: Allocation of Total Expenditure

(Rs. Crore)

Year	General Services	Social Services	Economic Services	Grants-in-aid and Contributions
2001-02	5637	4135	2381	67
2002-03	6719	5121	3557	58
2003-04	7438	5081	3543	73
2004-05	8028	5969	3857	-3
2005-06	8826	6029	4386	0
2006-07	9763	6594	3459	1912
2007-08	12241	7925	4102	2099
2008-09	12720	9654	5281	2265
2009-10	14002	10830	5870	2489
2010-11	15537	12590	7123	2778
2011-12 (RE)	19311	16727	10521	3450

Table A.5: Total Expenditure by Categories

(Rs. Crore)

Year	Disbursement of Loans and Advances	Capital Expenditure	Revenue Expenditure
2001-02	160	558	11662
2002-03	250	699	14756
2003-04	1292	640	15495
2004-05	196	682	17169
2005-06	287	817	18424
2006-07	349	903	20825
2007-08	893	1475	24892
2008-09	984	1696	28224
2009-10	877	2059	31132
2010-11	762	3364	34665
2011-12 (RE)	974	4949	45060

Table A.6: Committed Revenue Expenditures

(Rs. Crore)

Year	Revenue Expenditure	Salaries	Pensions	Interest Payments	Other Rev Exp
2001-02	11662	4164	1838	2489	3171
2002-03	14756	4250	2283	2947	5276
2003-04	15495	5048	2409	3328	4710
2004-05	17169	5336	2601	3613	5619
2005-06	18424	5653	2861	3799	6111
2006-07	20825	6638	3295	4190	6702
2007-08	24892	7694	4925	4330	7943
2008-09	28224	9064	4686	4660	9814
2009-10	31132	9799	4706	5292	11335
2010-11	34665	11178	5767	5690	12030
2011-12 (RE)	45060	15763	7731	6358	15208

Table A.7: Revenue Receipts by Categories

(% of GSDP)

Year	Own Tax Revenue	Non-Tax Receipts	Shared Taxes	Grants from GoI
2001-02	7.03	0.64	1.91	1.16
2002-03	7.77	0.72	1.82	1.00
2003-04	7.73	0.77	1.92	0.87
2004-05	7.52	0.69	2.02	1.10
2005-06	7.15	0.68	1.84	1.51
2006-07	7.77	0.61	2.09	1.36
2007-08	7.80	0.69	2.31	1.24
2008-09	7.89	0.77	2.11	1.33
2009-10	7.58	0.80	1.89	0.96
2010-11	7.84	0.70	1.86	0.79
2011-12 (RE)	8.10	0.84	1.89	1.29

Table A.8: Own Tax Revenues by Categories

(Rs. Crore)

Year	Taxes on Agricultural Income	Taxes on Sales, Trade, etc.	State Excise	Taxes on Vehicles	Stamps and Registration Fees	Land Revenue	Other Taxes
2001-02	2	4441	541	452	394	35	59
2002-03	6	5343	663	513	487	38	253
2003-04	9	5991	656	586	550	40	257
2004-05	5	6701	746	610	775	44	82
2005-06	6	7038	841	629	1101	44	120
2006-07	10	8563	953	708	1520	47	141
2007-08	22	9372	1169	853	2028	47	178
2008-09	12	11377	1398	937	2003	48	215
2009-10	28	12771	1515	1131	1896	54	230
2010-11	47	15833	1700	1331	2552	56	202
2011-12 (RE)	15	19428	2088	1419	3120	119	257

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